The Treasury

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Institute of Finance Professionals New Zealand Inc.

15 May 2019

Phase 2 of the Reserve Bank Act Review
The Treasury
PO Box 3724
Wellington 6140

Attention: Bernard Hodgetts and Alistair Birchall

By Email

Reserve Bank's Consultation Document: Safeguarding the future of our financial system (the Phase 2 Review) – Further thoughts about governance matters and operational independence

Thanks for your time last Monday to catch up about aspects of the Phase 2 Review on which INFINZ hadn't been able to do a written submission. As noted, this was primarily for reasons of time and work pressures, being a voluntary organisation with no resource for advocacy beyond what our board members can do, rather than because we didn't regard those matters as having policy significance.

I thought it would be useful to follow up on our meeting to flesh out some of the things we talked about. In doing so, I acknowledge that the process on this aspect of Phase 2 is advanced and don't expect that the views here will necessarily be able to be factored into the next consultation report-back, due in a few weeks. Also, because of the complexity and range of possible views on these matters, the notes here largely reflect some thinking I've done personally about these things, and some research in the context of advice I've given about them (which I understand has been discussed with the PSD). As such, while it's under the aegis of the advocacy work, it is not intended as a formal submission or for publication, although ultimately I have no issue if, for example, it had to be released under the OIA.

With that preamble, I'll try to set out my thinking about how "operational independence" interacts with oversight currently in the RBNZ Act (a 'positive' question), and how it ought to do so in the future under new legislation (a normative one).

To some extent these views are drawn from our engagement on the current regulatory capital proposal, but more significantly they are grounded in the importance with which we regard prudential policy and regulatory capital settings in New Zealand. This importance arises not just in terms of our acknowledged vulnerabilities (e.g. high level of household debt), but also because of our related high degree of reliance on debt capital for investment (and thus productivity).

The consequence of this fact is that our economy has a high degree of sensitivity to the cost and availability of debt capital, especially for bank-reliant sectors such as SMEs and rural borrowers. These, at least at first sight, create a tension (or 'trade-offs') between the two core components of the prudential mandate – soundness and efficiency, but in our view these two goals should be regarded as inter-dependent.

We think this has implications for the way that prudential policy is thought about and formulated, and is also a strong argument for policy-making to be 'joined up' in this area, while upholding the doctrine of central bank independence. For the reasons given below, we do not regard those propositions as contradictory. Rather, we agree with Masciandaro et al (2011) that accountability arrangements are "*the indispensable complement to independence*".

1. THE BALANCE BETWEEN INDEPENDENCE & OVERSIGHT IN THE EXISTING ACT

The relationship between independence and accountability/oversight is an important consideration in the Phase 2 review. It is also significant in relation to the concurrent regulatory capital review, where a number of submitters or commentators (including INFINZ) have recommended that the capital proposal should involve some independent input from (or organised by) agencies within broader government – e.g. Treasury or Productivity Commission. This raises the question whether more active Government engagement would be incompatible with "operational independence" or with the extant RBNZ Act.[1]

Perception of independence, and what that means

The Reserve Bank is regarded as 'operationally independent' in its conduct of prudential policy. That in itself is not controversial – the Reserve Bank clearly has the power to set prudential standards (s 74 RBNZ Act) and is the decision-maker in this regard – and this is consistent with the Basel Core Principles for Effective Banking Supervision (BCPs).[2]

However, an implication appears to have been drawn from this that prudential policy-making is or should be isolated from broader economic policy and from conventional oversight arrangements. Such an extension of the independence principle does not appear to be well-founded in the RBNZ Act itself, at least outside of monetary policy (and even then subject to clear constraints). Such an implication is not only broader than what is implied from the concept of "operational independence" in ordinary usage, it is also inconsistent with international best practice in supervision, in which independence is inherently tied to accountability, as noted in BCP Principle 2:

> "The supervisor possesses operational independence, transparent processes, sound governance and adequate resources, and is accountable for the discharge of its duties."

The suggestion of independence as carrying this broader implication is also difficult to reconcile with the accountability provisions of the RBNZ Act, and with the approach taken to macro-prudential policy, which is governed by a Memorandum of Understanding (MOU) setting out a formal basis for engagement between the Reserve Bank, Minister of Finance, and Treasury.

[1] Note we are not aware of the degree of engagement of agencies, including Treasury, on the current phase of the regulatory capital review – there is no indication about this in the background papers released on 25 January and doesn't appear to be anything on the Treasury website – so we have made no assumptions about this.

[2] Principle 2. This principle includes that the supervisor "is accountable for the discharge of its duties".

This appears to be something of an anomaly, and a gap in the checks and balances emphasised by Masciandaro/IMF,[3] given that prudential policies seem to have an economic significance that is more widespread, greater and more lasting than, for example, LVR restrictions (particularly given that the statutory basis for macro-prudential intervention is the same as for prudential regulation more generally). It also sets it apart from monetary policy, where the checks and balances are built into the legislation (ss 9 to 15), likely reflecting the greater focus on this area at the time the RBNZ Act was passed.

But, whatever its basis, the perception is important. Risks arising from it include that:

- policy proposals by the Reserve Bank are regarded as a fait accompli, detracting from engagement in consultation processes, or submitters lack access to 'other views' to inform their feedback;
- other agencies do not engage sufficiently in developing policies that have impacts on the wider economy or consequences for the Government's broader initiatives, missing opportunities for an integrated and coherent approach; and
- over time, the lack of effective engagement, oversight and accountability can erode the degree of focus on, and resources devoted to, this aspect of the Reserve Bank's role.

It appears that the Reserve Bank views itself as having a high degree of independence when formulating and implementing prudential policy. In its background paper setting out the analytical basis for its capital proposal, the Reserve Bank describes itself as "*an agency with delegated authority (and obligations) to make such decisions [here about society's risk appetite] on behalf of the public*".[4] The Reserve Bank's prudential mandate is not described in the RBNZ Act as a delegation, and there is nothing in the Act to suggest it should properly be characterised as such.[5] Although that term was unlikely to have been meant in a formal sense, it seems reasonably indicative of views held within and outside the Bank about the extent of autonomy.

Once again, this is undoubtedly correct so far as it reflects the independence to make prudential determinations. But it should not carry the implication that appropriate checks and balances are incompatible with operational independence, where they are transparent and clearly specified. Nor should the concept of operational independence lead to the inference that that the Government does not have a legitimate interest and role in providing input on broader matters about objectives, such as determining the risk preference of society.

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[3] Donato Masciandaro, Rosaria Vega Pansini and Marc Quintyn "The Economic Crisis: Did Financial Supervision Matter?" (IMF Working Paper WP/11/261, November 2011), pg 21. This related to separation of micro- and macro-prudential supervision, which has been ruled out, but would in principle apply to input from other agencies.

[4] Reserve Bank "Capital review Background Paper: An outline of the analysis supporting the risk appetite framework" (3 April 2019), pg 12.

[5] Compare for example ss 51 and 173(e) RBNZ Act.

Statutory basis for the prudential function

Under the RBNZ Act, only monetary policy is 'formally' independent — as indicated by the words "formulating and implementing" (ss 1A and 8 RBNZ Act). This independence is subject to carefully drawn boundaries, contained in ss 9 to 15 RBNZ Act, including detailed consultation, step-in and transparency procedures and obligations, formalised under the Policy Targets Agreement. These were recently bolstered under the Phase 1 amendments, which established a Monetary Policy Committee to replace the single decision-maker model.

The arrangements for prudential supervision are less well-developed. As noted above, this likely reflects that this was a new area at the time the RBNZ Act was drafted and that by far the greatest focus at that time was given to monetary policy and controlling inflation.[6] However, consistent with the BCPs, prudential policy-making is explicitly subject to the Act's broader accountability arrangements as well as some specifically directed to prudential regulation (most notably, financial stability reports).

Prudential supervision is not among the functions set out in Part 2 of the RBNZ Act, but is contained in the bank registration provisions in Part 5, again likely reflecting its narrow focus and impact at the time the current legislation was written. Under section 67 of the RBNZ Act, the Reserve Bank is empowered with registering banks and undertaking prudential supervision of them (section 67). Section 68 provides that those powers must be exercised for the purposes of:

(a) promoting the maintenance of a sound and efficient financial system; or

(b) avoiding significant damage to the financial system that could result from the failure of a registered bank.

Capital requirements are given effect under the ability to impose conditions of registration, in section 74 of the RBNZ Act. This section also provides the statutory basis for macro-prudential interventions (such as the high LVR restrictions).

In relation to regulatory capital, there is similarly limited reference or direction in the RBNZ Act, and none that would offer useful guidance about the extent or degree of independence. Section 78(1) of the Act provides that, in considering whether to register a bank, the Reserve Bank is confined to considering a number of specified matters, including the "*capital in relation to the size and nature of the business or proposed business*". The only other reference to capital as such relates to the content of disclosure statements (s 81AB).

The conditions of registration are bank-specific, but, in practice, they predominantly reflect prudential policies of general application contained in the Banking Supervision Handbook. As with the conditions of registration, the Handbook is an administrative instrument and not subordinate

[6] At the time the RBNZ Act was passed, the capital adequacy framework ('Basel I') had only just been formulated and had not been implemented (that happened in 1992). Prudential powers were included into the 1964 Act by a 1986 amendment. These were replicated in the 1989 Act to promote prudential behaviour by banks and to "*enhance the Reserve Bank's ability to implement the international agreement requiring banks to have 8 percent risk-adjusted capital ratios by 1992*" (refer *Hansard* 10426 (4 May 1988)). This is the only reference to prudential regulation in the 50-plus pages of the Second Reading, indicative of its lack of prominence at that time.

legislation. As such, decisions in relation to it are subject to judicial review, but not to the procedures for the review of regulations. Decisions about registration are also subject to natural justice protections for the banks affected (ss 74(3) and 77(3) RBNZ Act).

Beyond the above, prudential policy receives little attention other than in the accountability provisions discussed below.

Reserve Bank's form and structure

The Reserve Bank is a sui generis entity in New Zealand's government framework. It is a body corporate, which is a "bank" and "central bank" (ss 1A(1) and 5(1) RBNZ Act). It is not a department or a Crown entity (s 163A RBNZ Act), but it is subject to accountability arrangements similar to the latter, as described below.

Accountability provisions in Part 6 of the RBNZ Act

Part 6 of the RBNZ Act provides for accountability arrangements, inserted at the time the Crown Entities Act was enacted in 2004 (sections 162AA to 167). These provide for forward-looking accountability through an annual Statement of Intent (SOI) and reporting in relation to the SOI in an Annual Report, including as to prudential matters (162AB(1)). The purpose of the SOI to promote the public accountability of the Bank by: (i) enabling the Crown to participate in the process of setting the Bank's medium-term intentions and undertakings; (ii) setting out for the House of Representatives those intentions and undertakings; and (iii) providing a base against which the Bank's actual performance can be assessed (s 162AA(a)).

There is also a requirement for six-monthly Financial Stability Reports, which are mandated for the purpose of showing what the Reserve Bank is intending and undertaking in relation to its statutory purposes of soundness and efficiency, to enable "*an assessment to be made of the activities undertaken by the Reserve Bank to achieve its statutory prudential purposes...*" (section 165A).

These provisions contain a number of references to their accountability purposes and the responsibility in that regard of the Minister of Finance (and by extension the Treasury). Among other things, the Reserve Bank must assess the regulatory impacts of prudential policies under Part 5 and give those reports to the Minister. The provisions relating to the Reserve Bank's SOI contemplate comments from the Minister (s 162C).

Ministerial direction (s 68B)

The Minister of Finance may direct the Reserve Bank to have regard to a government policy that relates to the Reserve Bank's functions under Part 5 of the RBNZ Act (s 68B(1)). Tellingly, this power has never been exercised.

The power of direction was included in the RBNZ Act at the same time as the accountability arrangements in Part 6 and is consistent with arrangements applying under the Crown entities framework on which Part 6 was based.[7] Leaving aside the question of whether it is the correct accountability mechanism (e.g. whether it is consistent with the BCPs), it provides a further indication of legislative intent that the Minister of Finance has a role in ensuring prudential and

[7] Refer sections 104 and 113-115 of the Crown Entities Act 2004.

broader economic policies are aligned and that prudential matters are not isolated from broader government policy.

Section 68B may also offer some guidance in the objective of more clearly delineating operational independence and accountabilities, as recommended in the IMF FSAP,[8] as it separates matters of "government policy" – in which the Minister has a role – from operational matters – which are excluded from the power of direction. Specifically, section 68B(5) prohibits directions: (a) requiring performance or non-performance of a particular act, (b) bringing about a particular result or (c) in respect of a particular person.

Macro-prudential MOU

As noted above, macro-prudential policy is carried out under an MOU between the Reserve Bank and Minister of Finance, including that the Reserve Bank will keep the Minister and the Treasury regularly informed on its thinking on significant policy developments and will consult with them where macro-prudential intervention is under active consideration.[9]

The macro-prudential framework, like prudential policy more generally, is given effect under the conditions of registration, using the power in section 74 RBNZ Act. There is no explicit basis for the MOU in the RBNZ Act, but it is consistent with apparent intent of the accountability provisions and is not contradicted by any provision providing for independence of prudential functions. In addition, as noted earlier, under international best practice accountability is required for independence, not inconsistent with it (Principle 2, BPCs). Nonetheless, it would be desirable to clarify the legislation in this regard.

An accountability gap for prudential regulation?

When prudential supervision first came into the framework in the late 1980s, it did not have the same degree of economic significance, but was of concern primarily to the banks affected (and even then in a way that was generic to banks globally under the (then new) Basel framework) and there was a limited range of prudential tools.[10] In the succeeding 30 years – and in particular since the GFC – the economic significance of prudential regulation has grown and broadened, as has the range of prudential tools and approaches.

This has left prudential regulation in an anomalous position in terms of input and scrutiny. That is not a position explicitly mandated by the RBNZ Act and – in light of the accountability provisions in Part 6 – seems at odds with it. Despite those accountability provisions, both the Minister of Finance and the Treasury have tended to take a hands-off approach in matters of prudential policy. This contrasts to the position in relation to:

- monetary policy, which is subject to detailed provisions as to Ministerial input in sections 9 to 15 of the RBNZ Act, recently bolstered by new institutional arrangements established under the Phase 1 reforms; and

[8] Refer "Recommended Actions" on pg 70.

[9] Refer https://www.rbnz.govt.nz/financial-stability/macro-prudential-policy/mou-between-minister-of-finance-and-governor-of-rbnz (13 May 2013).

[10] Refer Phase 2 Report, pg 80.

- macro-prudential policy, which is the subject of an MOU between the Minister of Finance and the Reserve Bank, including that the Reserve Bank will keep the Minister and the Treasury regularly informed on its thinking on significant policy developments and will consult with them where macro-prudential intervention is under active consideration.

It is submitted that these arrangements are appropriate in light of the economic significance of monetary policy and macroeconomic interventions, as well as the general desirability of oversight and accountability, and that they apply equally to the prudential policy-making function.

Conclusions about current law

The RBNZ Act provides a clear mandate to the Reserve Bank to undertake prudential supervision of banks. But there is nothing in the RBNZ Act to suggest that operational independence carries the implication that prudential policy is to be formulated in isolation from broader economic policy or that Ministerial and Parliamentary scrutiny does not apply to it. It is appropriate and timely that these arrangements are being re-assessed and clarified as part of the Phase 2 review, but this does not alter the fact that Part 6 of the RBNZ Act contemplates, and provides a framework for, Government engagement on prudential policy.

2. INDEPENDENCE AND OVERSIGHT SETTINGS IN FUTURE

The broadening economic impact of prudential policy, and corresponding questions about the accountability and oversight arrangements in its formulation, are a key focus of the Phase 2 report. Advice to officials in connection with the Phase 2 review notes:[11]

> "Over recent years there has been a significant growth in the breadth and complexity of prudential regulation and with this comes a wider range of impacts on the wider economy. This raises the question as to whether there are appropriate safeguards in place as to the setting of regulatory requirements. While it is desirable to delegate matters of technical detail to regulatory agencies, the question is whether the prudential requirements are subject to too little scrutiny, particularly in comparison with the IPS Act, the NBDT Act and the financial markets regime."

This is a good summary of the issues to be addressed with oversight of prudential policy-making. Reforms of the Reserve Bank's governance arrangements (e.g. the board's role and powers) and institutional structure (e.g. the Reserve Bank administering its own legislation) are important, *but are unlikely on their own to be sufficient in bridging this particular accountability gap.*

The Phase 2 paper, in chapter 7, correctly focuses on how accountability arrangements mesh with best practice for the operational independence of prudential supervisors. The arguments for that operational independence are well-supported, and it is also necessary for compliance with best practice, in the form of Principle 2 of the BCPs: *Independence, accountability, resourcing and legal protections for supervisors.* Importantly, as the title suggests, this principle is not only consistent with robust accountability arrangements, it requires them.

Chapter 7 also outlines factors helping to determine when governments should delegate policy responsibilities, set out below with some comments:

[11] Dr James Every-Palmer *Reserve Bank Prudential Regulation of Banks* (August 2017).

Delegation factor	Comments
The policy goal can be specified.	Broadly this is true (soundness and efficiency), but as pointed out by Masciandaro et al (2011), "*the contract between the supervisor and society will always be radically incomplete given the great range of contingencies that can occur in regulation and supervision. Thus, it will be extremely difficult to precisely specify the agent's objectives*". This means that engagement is critical in bridging the gaps through time and in relation to particular matters as they arise – i.e. in relation to policy development, there needs to be an ongoing connection between the 'principal' (the Government, which in turn is accountable to the public), and the 'agent' (the authority allocated the relevant function).
There exists a relevant community of experts outside the agency.	Because that community here primarily is the registered banks, a well-resourced Government agency (Treasury) is indispensable in ensuring appropriate checks and balances are in place.
The agency will not have to make big choices on distributional trade-offs	Arguably, such choices are involved with both monetary and prudential policy functions. This is where there is an accountability gap. The former has checks and balances and the latter doesn't (other than the Part 6 accountability provisions, which are too generic, and the MOU, which unfortunately is restricted to macro-prudential tools).
Parliament has ability to hold the agency to account and assess performance	Again, this is the critical gap, and it does not arise because of any best practice requirement relating to operational independence (ref BPC Principle 2 as well as the general principle per Masciandaro/IMF that accountability arrangements are "*the indispensable complement to independence*").

Other comments on the independence issues raised in chapter 7:

- "*The Reserve Bank has significant powers to take financial policy actions without Ministerial consultation or consent*" (pg 79): This is consistent with operational independence, since ultimate decision-making is a matter of implementation rather than formulation. *It should not be regarded as ruling out engagement and input on policy formation*, which is already contemplated under the SOI and similar arrangements. Those should be supplemented with specific provisions, which could adopt as a model the existing macro-prudential MOU.

- "*While the case for operational independence is strong, it is nonetheless more challenging for financial policy than it is for monetary policy to both define the limits of this independence and design the accountability mechanisms necessary to support long term legitimacy*" (pg 79): Agree, prudential regulation has more characteristics of an incomplete contract than monetary policy, where the goals can be established more clearly (target inflation, and now sustainable

employment) and accountability is more straightforward (inflation and employment levels are visible and continuous; financial crises will hopefully be permanently avoided).

The conventional responses to any incomplete contract are therefore relevant and, with the fluid world of prudential regulation, inherently need to take place through time. These include: a transparent and robust framework for engagement between agent and principal; clear specification of goals and risk preferences, updated as required; and an understanding that the level of input will be dependent on materiality of the matter or decision under consideration. While the provisions need to be carefully drawn, it is neither possible nor desirable to seek to pre-bake too much of this in advance – ongoing decisions and responses are intrinsic to incomplete contracts, so frameworks are more important than prescriptions.

In relation to protections required both to "delineate roles" (as recommended by the IMF in the recent FSAP), and to maintain the integrity of operational independence consistent with best practice for prudential supervision, it is likely best to define this both in the positive – clear frameworks for engagement and oversight – and in the negative – through protections to ensure that inputs are in the realm of policy formulation and goal setting, and not implementation in particular instances.

In the latter regard, the provisions of section 68B(5) may offer some guidance, as suggested previously. This separates matters of "government policy" (s 68B) from operational matters, such as directions to perform particular acts, bring about particular results or as relate to particular persons. (This is not to say that the power of direction remains appropriate – it is certainly not a substitute for appropriate accountability arrangements.)

Although this is a challenging task, it carries an importance that has grown in line with the increased significance and complexity of prudential regulation. The macro-prudential MOU provides a useful starting point for provisions that could be included in the new legislation in relation to prudential policy-making, as a counterpart to those already applying to monetary policy.

Macro-prudential MOU a precedent for broader prudential arrangements?

As noted above, the use of macro-prudential interventions is subject to an MOU between the Reserve Bank and the Minister of Finance, which provides for the following arrangements (among others):

- The Reserve Bank will keep the Minister and the Treasury regularly informed on its thinking on significant policy developments relating to macro-prudential policy, and of emerging risks to the financial system.
- The Reserve Bank will consult with the Minister and the Treasury from the point where macro-prudential intervention is under active consideration, and will inform the Minister and the Treasury prior to making any decision on deployment of a macro-prudential policy instrument.
- The Reserve Bank will consult with the registered banks prior to deployment of a macro-prudential policy instrument in the manner required under section 74(3) of the Act.
- The Financial Stability Report will report on the reasons for, and impact of, any use by the Reserve Bank of macro-prudential policy instruments.

- Any decision on macro-prudential intervention will be taken by the Governor, and the Reserve Bank will be "fully accountable to the Board, Minister and Parliament for its advice and actions in implementing macro-prudential policy, under the normal conventions outlined by the Reserve Bank Act".
- The appropriateness and effectiveness of macro-prudential policy decisions will be reviewed on a regular basis. This will include an assessment of the key judgements that led to decisions on whether or not to adjust macro-prudential policy. The Reserve Bank will report the results of its assessment in its Financial Stability Report.

It is submitted that such a framework is sound, and reflects an *appropriate balance* between oversight and operational independence (see in particular the penultimate bullet point). Although we had suggested at our meeting that it could be defined by reference to economic significance, in practice this may be difficult to draft in a clear way and is likely inherent in the divide between 'policy' and implementation, building on existing provisions in the Act.

Achieving the accountability necessary for independence

From a policy perspective, independence and accountability are not an incompatible dichotomy. Ongoing engagement is necessary because of the nature of prudential supervision as an "incomplete contract". This inherently requires the 'agent' and the 'principal' to work together through time to fill the gaps as they arise in particular situations. It is not a case of complex drafting of pre-baked solutions – if that could be done effectively, it would not have the characteristics of an incomplete contract.

Other thoughts on the accountability chapters

Comments in relation to other matters in Chapters 5 through 9 of the Phase 2 paper are set out below.

Phase 2 proposal/discussion	Comments
Separation: Should the prudential function be in a separate entity or is an "enhanced status quo" option preferable? The enhancements here could include clearer objectives, changed governance and accountability arrangements, and resourcing.	We understand that separation has been ruled out. We agree that greater resourcing for prudential supervision (as recommended in the IMF FSAP) is not dependent on separation – this should be a priority and need not await new legislation.[12]
Governance: This considers the RB's status within the State sector governance arrangements, with the aim that its governance framework is well-suited to its functions and supports accountability.	There doesn't seem to be any strong reason for the RB to sit outside the CEA – other entities are included for which independence is a critical part of their make-up (e.g. Pharmac). Equally there is plenty of precedent for CEs to have their own legislation. It shouldn't matter so long as the accountability frameworks are robust.

[12] Section 159(3) provides that the 5-year funding agreement may be varied from time to time by agreement between the Governor and the Minister of Finance.

Independence: What should be the scope of the RB's operational independence?	Refer comments in the body of the letter.
Administration of legislation: Should the RB continue to administer its own legislation?	We agree that this is an unjustified anomaly. Changing this would contribute to other agencies gearing up to address components of the RB's remit that carry 'all of government' considerations.

Closing remarks

The policy issues in this part of the Phase 2 review are very important because prudential policy decisions can have impacts which are significant in quantum and breadth across the economy. This means that engagement with other parts of government is important.

The desirability of being more joined up on prudential policy flows both ways. The critical function of banks in funding NZ Inc, and their resilience in doing so, make it equally important that other branches of Government take into account the potential financial stability impact of their decisions.

We have appreciated the open nature of the engagement we've had both with the Phase 2 team and with the PSD. We would be happy to discuss the matters in this letter with you further, and we look forward to engaging as well on the next part of the Phase 2 review.

Regards

[1] [1]

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